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Brexit and the City

By Leila Simona Talani

Abstract

The decision of British Citizens to vote for Brexit on the 23rd of June 2016 will pose a number of challenges to British institutions and the British capitalist system. This contribution explores how the institutional "pragmatic adaptation" of the City of London, relying on the friendly regulatory and economic policies enacted by the British government, will help the city of London adapt to the challenges of globalization and the changing nature of British relation with the EU.

Introduction

On June 23, 2016 British citizens finally voted for Brexit, opening new questions about what model will British capitalism be following in the future.

If globalization did not pose any a real challenge to the City of London, Brexit might instead make it more difficult for the City to fully gather the benefits of financial globalization. Scholarly interventions have demonstrated that globalization could have indeed increased the bargaining power of the City inside the national polity, as its economic position is very likely to improve in the future thanks precisely to globalization. This will be the case no matter which definition of globalization we take into account, and regardless of whether the analysis is carried on at the macro or at the micro level.

Starting from a quantitative definition of globalization, at the macro level this implies a trade-off between national monetary autonomy and stable exchange rates. As exchange rate stability is necessary for trade liberalization, countries will need to renounce their macro-economic autonomy and integrate their monetary policy-making through global agreements and institutions.

However, the decision by the UK government not to join the EMU demonstrates that, in the trade-off between the stability of the exchange rates and autonomous monetary policy, some countries, and especially some domestic actors (notably the City of London), might still prefer the latter. The reasons are many. Primarily, financial services have everything to gain from being able to set interest rates at a higher level than the other financial centres and to keep the level of domestic regulation under control as this represents a relevant competitive advantage in attracting short- and very short-term capital. Moreover, unstable exchange rates may and do actually signify a substantial source of revenues for the City of London. Finally, the City of London is most likely to be one of the main winners of financial speculative practices.

From the micro point of view, when adopting a factorial approach globalization favours capitalists and skilled labour and therefore, undoubtedly the City of London. Furthermore, if an interest group is able to credibly threaten to leave the country, its bargaining power increases. As a consequence, globalization reduces the capacity of the government to disregard the preferences of the most mobile factor, which is capital and financial capital in particular, increasing the negotiation and political power of the owners of such capital: the City of London.

Finally, adopting a sectoral instead of a factorial kind of analysis, to the extent to which the City remains competitive internationally, with a high degree of openness of the markets, it will improve its position not only with respect to labour but also with respect to industrial capital.

From the qualitative point of view, around-the-clock access to financial markets all over the globe does not threaten the geographical allocation of financial power. This remained surprisingly stable and concentrated in three centres: New York, London and, to a more limited extent, Tokyo. This concentration is unparalleled in any other kind of industry and it is also extremely durable. London is the most successful of these centres and its position has certainly been strengthened by its ability to attract expertise and highly valuable skills from all over the globe, including the EU. This resulted in a virtuous circle, which made London more and more attractive to highly skilled labour and this, in turn, favoured the concentration of financial services in the British capital. Brexit most likely will revert this dynamics making London less attractive to highly skilled labour from the EU and thus also limiting the concentration of expertise and knowledge, which represents such a valuable competitive advantage for the City of London.

Moreover, Brexit can offset also other benefits of globalization, as it will undermine the ability of the City to have full access to EU markets without discrimination. This would be particularly true if the EU decides to go ahead with the Capital Markets Union, not only because the City is unlikely to be allowed to take part in it, but also because not being in the EU could mean the imposition of barriers to the free movement of capital outside the EU.

If it is true, as the analysis below will show, that the City thrives on the liberalization of financial markets, having barriers imposed by the EU as a consequence of Brexit would represent a major blow on the hegemonic position of the City in the international context.

Moreover, it remains to be seen if a stand-alone UK will be able to negotiate the same trade conditions as the EU when it comes to international trade agreements such as, for example TITP.

Maybe, at this point, the pragmatic adaptation, relaying uniquely on the power of the Bank of England and the HM Treasury, will not be enough to guarantee the best possible treatment to the British financial sector internationally.

In the next section we will explore how this "pragmatic adaptation", relying on the friendly regulatory and economic policies enacted by the British government, has helped the City's revival and ultimate success in the period before and after the Global Financial crisis.

Pragmatic adaptation and the success of the City of London before and after the Global Financial Crisis

Within the context of "pragmatic adaptation", this section reviews British economic policy making between before and after the Global Financial crisis to verify to what extent the City's special relation with the Bank of England and the Treasury confirmed and enhanced the hegemonic position of the City of London within the British capitalist structure as well as globally.

This section will try to assess whether the financial crisis that hit the global economy unexpectedly in August 2007, producing consequences comparable to the ones experienced in the course of the 1930s, has put under discussion the hegemonic position of the City of London in the domestic and international context.

It is not here the place to address the theories relating to the causes and consequences of the Global Financial Crisis (Talani 2010). It is worth noting, however, that the crisis, although originating from the U.S. housing and mortgaging markets, found very fertile ground in the uncontrolled possibility of the financial markets to develop and sell new financial instruments that allowed the banking sector to greatly expand their capacity to extend loans and provide mortgages even to the least solvent clients. Therefore, the idea that finance was doomed after the crisis was very widespread (Bishop 2009).

In the U.K. in particular, it was felt that the financial sector could not be the main specialization of Britain any longer; the country will have to find a new one. Many British analysts, in the immediate aftermath of the global financial crisis insisted on the changes that the global financial crisis would have not only on the British economic strategy, but more importantly on the structure of the British economy itself. It seemed almost inevitable that the role of the financial sector would decline, although it did not clearly emerge what would take its place. Further, the centrality of the City of London as the "European" financial capital or as a global financial power was felt to have been put in danger by the crisis. This led economists and commentators to identify as a solution joining the Euro-area. However surreal it may seem in light of the recent developments of the Euro-zone's sovereign-debt crisis, the case for the U.K. joining the EMU had never been as pressing as at the start of the global financial crisis. Leading scholars and public opinion-makers in the U.K. joined the debate promoting accession on various occasions (Bishop et al., 2009).

However, in December 2010 the financial and economic situation in Europe and especially in the Euro-area was still heavily compromised. The main problems existed in the interplay between sovereign debt difficulties and the weakness of the banking sectors in some countries within the Euro-area. Taken together, these issues could bring serious consequences for the sustainability of the EMU as a whole.

At the end of 2010, it seemed that the shelter provided by the Euro and by the ECB against the worst consequences of the global financial and economic crisis had failed to work its magic. This made the British government feel good about having decided to ignore the calls to join the EMU which had been voiced in many sectors at the very beginning of the financial turmoil.

But what was the impact of the crisis on the City of London? Lord Adair Turner, the Financial Service Authority chairman, during the tragic week of October 2008 told The Guardian that the days of soft-touch regulation were over, warning the City that higher-paid regulators would ask tougher questions in the wake of the credit crisis. However, by now it is clear that the consequences of the crisis have been felt mainly by the workers of the British and the global financial sector. The ILO estimates total announced layoffs of 325,000 between August 2007 and February 2009 (ILO 2009:14). This figure underestimates the real number of jobs lost given that not all institutions announced their employment decisions in advance; in addition, it does not include independent mortgage brokers, other independent contractors, or the myriad of small financial firms which were likely to disappear as a consequence of the crisis.

Furthermore, it seems clear that the loss of jobs experienced by the City of London parallels similar layoffs in all the other major financial centers. This means that the position of the City of London as one of the most important global financial players does not seem to have been put under discussion. Moreover, much of the restructuring which led to the rationalization of the workforce, including some nationalizations, was the result of consolidations based on mergers and acquisitions which actually enhanced the overall importance of the financial sector globally and within the UK. Indeed, there is no evidence that the City of London lost its market share and leadership in the European financial sector.

To prove this point it is enough to look at the data in the figure below. In 2014, the City was contending the primacy of financial markets and activities only with New York. Moreover, the outlook for many of those markets and activities had actually improved after 2008. This was the case, for example, for the foreign exchange turnover, for OTC derivatives turnover, for marine insurance and premium income, and for private equity investment.

Figure Error! No text of specified style in document.**-1 Financial markets share by country (%)-UK share of financial markets**

FINANCIAL MARKETS SHARE BY COUNTRY (%)

	UK	US	Japan	France	Germany	Singap.	H.Kong	Others
Cross-border bank lending (Sept 2014)	17	11	11	8	8	3	4	38
Foreign exchange turnover (Apr 2013)	41	19	6	3	2	6	4	19
Exchange-traded derivatives, number of contracts traded (2014)	6	36	2	---	10	---	1	45
Interest rates OTC derivatives turnover (Apr 2013)	49	23	2	7	4	1	1	13
Marine insurance net premium income (2013)	26	5	7	4	4	1	1	53
Fund management (as a source of funds, end-2013)	8	46	7	3	2	---	1	33
Hedge funds assets (end-2013)	18	65	2	1	---	1	1	12
Private equity – investment value (2013)	13	53	2	5	2	1	---	24

Market leader

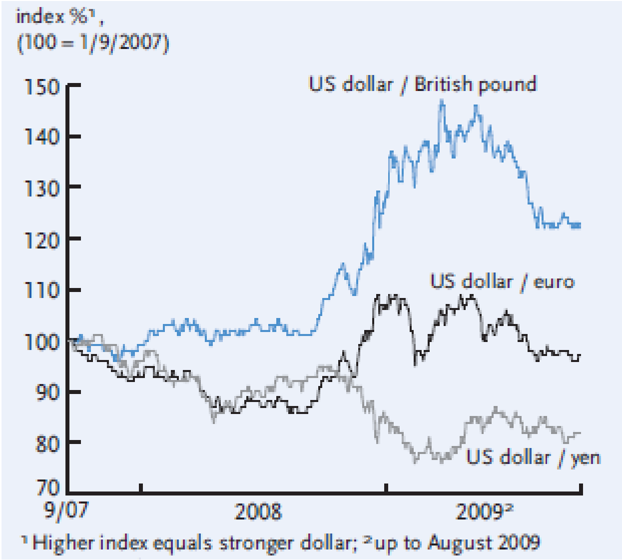
UK SHARE OF FINANCIAL MARKETS (%)

	1992	1995	1998	2001	2004	2007	2010	2012	2013	2014
Cross-border bank lending	16	17	20	19	20	18	18	18	17	17
Foreign exchange turnover	27	30	33	31	32	35	37	–	41*	–
Exchange-traded derivatives	12	12	11	7	7	6	6	7	6	6
Interest rates OTC derivatives turnover	---	27	36	35	42	44	46	–	49*	–
Marine insurance net premium income	24	21	14	18	19	17	20	22	26	–
Fund management (as a source of funds)	---	---	8	8	8	9	8	8	8	–
Hedge funds assets	---	---	---	9	20	20	19	18	18	–
Private equity investments	---	---	---	6	13	7	17	10	13	–

**April 2013;*
Source: TheCityUK calculations and estimates

Moreover, the City was actually able to cash on the global financial crisis. For example, unstable exchange rates may and do actually represent a substantial source of revenue for the City of London. Indeed, the volume of foreign exchange trading surged to record levels at the outset of the credit crisis as rate cutting from central banks and high volatility in exchange rates (Fig. below) caused a flight from emerging market currencies to "safe-haven" currencies such as the US dollar (IFSL 2009).

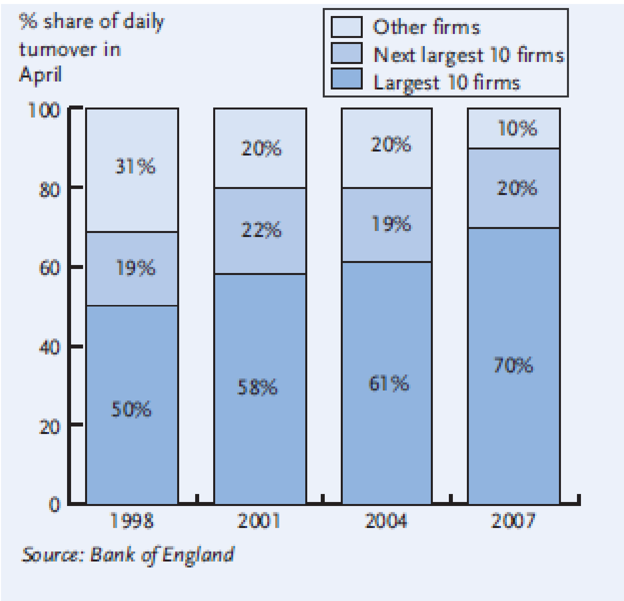
Figure -2: Exchange rate volatility since the start of the credit crisis



Source: IFSL 2009

Global bank revenues from foreign exchange trading benefited from relatively strong trading volumes since the start of the credit crisis and from higher commissions that resulted from a widening of foreign exchange trading spreads. The UK was the main geographic centre for foreign exchange trading with nearly 36% of the global total in April 2009. Average daily turnover on the UK's foreign exchange market totalled $1,269 billion in April 2009, with a further $81 billion traded in currency derivatives (IFSL 2009). In the UK, the share of the largest 10 institutions rose from 61% to 70% between 2004 and 2007, continuing the trend from the 1998 and 2001 survey. Needless to say, London was the centre for foreign exchange trading (see below).

Figure Error! No text of specified style in document.**-3 Concentration of Foreign Exchange Market in the UK**



Overall, the City not only survived the blow but it could be argued that it turned it at its advantage.

There is, however, the possibility that things can get worse for London as a financial centre. A threat that the circumstances that have allowed London to thrive in the last few decades may be put under discussion through a radical tightening of financial service regulation. The success of the City of London has always been determined by its ability to adapt to the changing environment. Therefore, in the absence of regulatory constraints, its markets and institutions will certainly be able to react to any changing situation. However, it is precisely this capacity to change quickly and react to the changing global environment that could be put under discussion by adopting strict financial markets and banking sector regulation, including the minimal regulatory requirements connected to entry of the UK into the EMU.

Will this happen?

The need for global economic governance of the banking and financial sector has been advocated in a number of international forums. In the U.S., the Obama administration scored an unexpected victory in favor of more regulation with the passing of the Dodd–Frank Wall Street Reform and Consumer Protection Act in July 2010. At the European level, however, to date there is nothing like a pan-European regulatory regime for the EU and Euro-area banking and financial systems.

The transformation of the existing European supervisory committees on January 1, 2011 into the European Banking Authority (EBA) based in London, and the establishment of the European Securities and Markets Authority (ESMA) in Paris and of the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt to create the new European Supervisory Authorities (ESAs) to be inserted in the European System of Financial Supervisors (ESFS) does not seem to address the issue substantially. National authorities remain responsible for the day-to-day supervision of individual firms, with the new European architecture only providing an overarching European framework for financial supervision[1].

Even after the global financial crisis, the restructuring of the European supervisory architecture, and the partial creation of the European Banking Union, in the EU and Euro-area, banking and financial supervision remains predominantly in the hands of the national central banks.

Even more importantly, in the new British regulatory environment, following the events of October 2008, controls are still in the hands of the Bank of England especially after the Chancellor of the Exchequer of the newly elected coalition Government announced the abolition of the FSA. Thus the new system, retains the in-house structure of control for the City of London and banking supervision. So which are the challenges that the City of London will have to face in the future?

This is the subject of the following section of this contribution.

Globalisation and the future of the City of London inside or outside the EU

Globalization is one of the most hotly debated topics within the social sciences, and certainly one that has captured our imagination when looking toward the future. Globalization is not only the present, but also the future of politics and economics, and no discussion regarding future scenarios can avoid addressing it.

How will globalization affect the future of the City of London? Will financial globalization signal the end of the City's hegemony or will it guarantee its future success?

Questions related to how globalization affects domestic actors cannot be disentangled from a more general and in-depth analysis of globalization and its definitions.

The notion of globalization is not without controversy both within the academic debate and in the wider public discourse. Despite the great success of this concept in recent decades there is still some degree of confusion about its definition, and the discussion is still open about precisely how globalization modifies the capacity of the state to intervene in the domestic and in the global economy (Busch 2008:5).

[1] For more details see http://www.consilium.Europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117747.pdf as accessed on December 21, 2010.

However, it is possible to classify positions adopted by scholars into three broad groups, alongside the three traditional approaches to International Relations/International Political Economy (IR/IPE) (Dicken 1999:5): First, those who deny outright the very existence of the phenomenon of globalization (Hirst et al. 1999a; 1999b; Thompson 1993); second, those who recognize it but tend to give only a quantitative definition of globalization (Held et al. 2000; Holm et al 1995:3) third, those who adopt a qualitative definition (Mittlemann 2000; Hay et al. 2000; Dicken 1999;2003).

In this section, we shall deal with each of these approaches to the definition of globalization and their consequences for the future of the City of London both inside and outside the EU.

Let us start from a classical quantitative view of financial globalization. This has been well summarized by Cohen (1996):

"Financial globalization (or internationalization) refers to the broad integration of national markets associated with both innovation and deregulation in the postwar era and is manifested by increasing movements of capital across national frontiers. The more alternative assets are closely regarded as substitutes for one another, the higher the degree of capital mobility" (Cohen 1996:269).

Adopting this definition, capital mobility becomes the constituent element of financial globalization (Obstfeld et al. 2004). In macroeconomic terms, the problem is called the "inconsistent quartet" (Padoa-Schioppa 1994), the "unholy trinity"' (Cohen 1996) or the "trilemma" (Obstefeld et al. 2004:29), and posits that in an economic environment characterized by free capital movement, national monetary autonomy becomes an alternative to keeping stable exchange rates. The case rests on the argument that complete capital liberalization, (as implied by the quantitative definition of financial globalization) and exchange rate stability, (as necessary, in theory, for international trade to continue unhindered) are incompatible with divergent national monetary policies.

Although in macroeconomic terms this argument is certainly sound (or, at the least I am not in a position to criticize it), the British case is particularly relevant in highlighting how financial globalization did not particularly decrease the power of the City of London as defined here. The main point is that in the trade-off between the stability of exchange rates and autonomous monetary policy, some domestic actors (notably the City of London) might still prefer the latter, as they have demonstrated in their position toward joining the Euro area (Talani 2010). This happens for some concurring reasons.

Some sectors, like financial services, though perfectly integrated at the regional level might still prefer to keep autonomous monetary policy decision-making at the national level. In particular, setting the interest rates at a higher level than other financial centers represents a relevant competitive advantage in attracting short- and very short-term capital. This, of course, is harmful for industrial activity. However, here the issue becomes one of power relations between domestic economic sectors or interest groups. In the context of globalization, the issue is also influenced by the extent to which the industrial sector is actually relying on domestic production as opposed to production abroad (Dicken 2003).

To conclude the discussion of how the British financial sector will gain from globalization at the macro level, it is not unlikely that London will be on the winning side of speculative practices (Guth 1994; Lilley 2000). Following is just one example: In 2008, the Financial Services Authority (FSA) was compelled to pass emergency rules banning the short-selling[2] of UK bank shares in the City of London after the practice brought the HBOS share price to a collapse[3]. Well-known City operators are believed to have profited from short-selling sub-prime mortgages and betting against HBOS[4]. Hedge funds in the City of London are said to have made at least £1 billion in profits by shorting HBOS shares in June and July 2008, fuelled by City rumors that the bank was in financial distress. At one point in June of that year, a single fund, Harbinger Capital, traded more than three per cent

[2] Short-selling is selling borrowed shares in the hopes that their price will fall and that they can be bought back at a profit later on.
[3] The ban was then lifted in January 2009
[4] See Guardian, various issues.

of all HBOS shares, and is said to have made more than £280 from shorting the bank. Harbinger was run by Philip Falcone, a former Barclays trader who earned £1.7 billion in 2007 alone[5].

It is, however, at the micro level (i.e. at the level of sectoral and domestic interest group analysis) that we see how the City of London can gain from globalization.

As Cohen correctly states, "owners of mobile capital thus gain influence at the expense of less fortunate sectors including so-called national capital as well as labor" (Cohen 1996:286).

How does this happen? To answer this question, it is necessary to adopt a domestic politics (or inside-out) approach to the international political economy.

Assuming that globalization is defined in quantitative terms as "growing global trade and financial flows" (Frieden and Rogowski 1996: 26), by applying the Heckscher-Ohlin/Stolper-Samuelson approach, it is possible to derive some interesting propositions about the distributional consequences of globalization. This would imply a rise in the domestic prices of goods whose production is intensive in the given country's abundant factors and a fall in the prices of those goods intensive in scarce factors. In this context, globalization would benefit the owners of abundant factors and disadvantage those who own scarce factors (Frieden and Rogowski 1996: 37). Therefore, as developed countries are characterized by an abundance of capital and a shortage of unskilled labor, globalization favors capitalists and skilled labor while unskilled labor is at a disadvantage. (Frieden and Rogowski 1996: 40). This is relevant for our domestic politics analysis of who wins and who loses from globalization as the City of London is composed exclusively by capitalist and skilled labor and has everything to gain from liberalization from this perspective.

There are, however, two further dimensions that strengthen the argument that the City of London will certainly gain from globalization. First, we must consider that on the basis of this analysis, the power of an interest group to assert its preferences is directly related to its capacity to move, which in turn depends on the mobility of its factor. If an interest group is able to credibly threaten leaving the country, its bargaining power increases. Therefore, globalization reduces the capacity of the government to disregard the preferences of the most mobile factor, which is capital— and financial capital in particular— and increases the negotiation and political power of the owners of such capital: to wit, the City of London (Kehoane et al 1996:19; Busch 2008:8).

Moreover, adopting a sectoral rather than a factorial type of analysis, through the application of the specific factors approach (also known as Ricardo-Viner) the result is even more clearly supportive of the view that the British banking sector has everything to gain from globalization (Frieden and Rogowski 1996: 38).

This perspective suggests that factors like land, labor or capital are normally used for a specific activity or production, and therefore only price changes in their specific activity or production (not in all of the uses of the factors) will affect them. To apply it to the case of the UK, if capital is used specifically for banking and financial transactions when the terms of trade in banking change, only the banking sector will gain, not all capital. Overall, the application of the Ricardo-Viner variant implies:

1) That the benefits of globalization will vary with the specificity of the relevant actors' assets
2) That the most competitive sectors will gain more
3) That political pressure will happen at the sectoral rather than at the factorial level.

There is no doubt that financial capital is an abundant factor in the UK. Therefore, to the extent to which the City remains competitive internationally, and a high degree of openness is guaranteed, it will improve its position not only with respect to labor but also, more importantly given the approach adopted here, with respect to industrial capital.

Let us now address the question from the perspective of a qualitative definition of globalization. As detailed above, technological change is at the core of the qualitative definition of globalization, bringing about changes in the productive and in the financial sphere (Dicken, 2003:85).

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[5] See *The Telegraph*, web-site http://www.telegraph.co.uk/news/uknews/2977387/Protect-bank-shares-from-short-selling-ministers-told.html as accessed on June 28, 2010.

It is technology, therefore, that produces financial globalization, defined here as the existence of around-the-clock access to financial transactions all over the world (Dicken 2003: 443).

Susan Strange identified the three most important technological changes that have produced financial globalization: computers, chips and satellites (Strange 1998: 24-26):

"Computers have made money electronic…by the mid-1990s computers had not only transformed the physical form in which money worked as a medium of exchange, they were also in the process of transforming the systems by which payments of money were exchanged and recorded" (Strange 1998: 24).

Chips (microprocessors) have allowed for the credit card revolution and will soon allow for a "smart card" revolution as well (Cohen 2001). Finally, satellites are the basis of global electronic communication (Dicken 2003:85-120).

It is impossible not to understand the implications on financial services in terms of increase in productivity; patterns of relationships and linkages between financial firms and clients, and within the financial community; velocity and turnover of investment capital and capacity to react to international events immediately (Dicken 2003:443).

But does this also mean that the physical location of financial markets loses significance or that financial elites become disentangled from national boundaries?

There is some consensus in the literature that financial globalization has "made geography more, not less, important" (Dicken 2003:59) (Coleman 1996:7). On the one hand, some financial products contain information which is the result of long, well-established business relationships and this remains the case with financial globalization. Equities, domestic bonds and bank loans have indeed a large amount of domestic information embedded within (Coleman 1996:7).

Most importantly, however, it is worth noting that despite the significant emphasis on financial globalization, the location of global financial power has remained surprisingly unchanged and concentrated in a handful of urban centers, namely New York, London and, to a more limited extent, Tokyo. This concentration is unparalleled in any other kind of industry and it is also extremely stable (Dicken 2003: 462).

In fact, London is the more broadly based financial center and its position does not seem to have changed in the last decade—the decade of globalization. If anything, with respect to many of its main markets and services, its position has improved.

However, if openness is reduced, as, for example, by closing the European single market to the UK as a consequence of a Brexit, all the advantages of globalisation are likely to be off-set.

All the above might explain why the City of London was against a Brexit. The City of London Corporation has openly supported Britain remaining in the EU.

A survey of 147 UK based financial services firms found 40% chose the UK over other centres because of access to the EU. 81% of 98 fintech start-up business published by Innovate Finance, voted to stay in the EU, this was comparable to the survey conducted by Tech London Advocates in 2015[6].

Not a single financial trade association has been favourable to Brexit, and the representatives of major City institutions such as Lloyds of London, the London Stock Exchange, Aviva, Goldman Sachs, HSBC, Barclays, Prudential, RSA, Standard Life and Santander have all expressed their institutions' wish that Britain will decide to remain in the EU. The reasons have been perfectly illustrated by JP Morgan. If the UK stays in the Single Market, the institutions based in the City have a passport to operate everywhere else in the EU without the need to have separate businesses in other countries, with all that this means in terms of different authorisation processes, regulation as well as staffing costs. For example, of the 20,000 staff JP Morgan has in the European Union, 19,000 are in the United Kingdom, mainly in London, but also in Bournemouth and Glasgow[7].

[6] See https://www.cityoflondon.gov.uk/about-the-city/how-we-make-decisions/Documents/implementing-markets-union.pdf as accessed on April 28, 2016.
[7] See https://www.cityoflondon.gov.uk/about-the-city/how-we-make-decisions/Documents/implementing-markets-union.pdf as accessed on April 28, 2016.

Conclusion

Summing up, what really counts for the prosperity of the City is a relaxed regulatory environment, which, of course can be guaranteed by a Brexit. However this is a necessary but not sufficient condition for the City to maintain its hegemony both domestically and internationally in the globalization era. The second, vital condition is open access to markets globally, but also within the EU. This can be easily jeopardised by a Brexit as it is highly unlikely the EU will grant the UK similar conditions of access to its markets as if it were still a member of the club. However this can, maybe, be a matter of negotiation of the exit terms.

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